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Five years on: Myths and lessons from post-collapse Iceland – and the Eurozone debt crisis seen from the North

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Introduction

“Iceland didn’t bail out bankers,” “the collapse of the Icelandic banks didn’t come at any cost to Icelandic tax-payers,” “devaluation of independent currency saved Iceland,” “Iceland provides an example on how to deal with a financial crisis” – and “Iceland was back to growth by summer 2011, 2 ½ years after a total melt-down of the Icelandic financial system in October 2008 and unemployment is now measured to be 4,4% (4,9% seasonally corrected) from peak of 11,2% (8,4% seasonally corrected) in May 2009.” These are common statements about the Icelandic economy. The last one is true, but only tells part of the story, while the rest is either misleading or wrong. In spite of occasional good news, Iceland will not fully recover from financial collapse until capital controls, in place since November 28 2008, are abolished. This seems unlikely to happen in the near future.

Iceland cannot be held up as a role model for other countries. However, there are two rarely noticed Icelandic policies that do point to a lesson. These policies have worked in earlier debt crises and are supported by economic theory. They are targeted debt relief for households and companies and a possible discharge from bankruptcy after just two years. These two measures would benefit all debt-ridden EU countries but are currently being ignored by policymakers, possibly slowing down recovery.

Moreover, the Icelandic experience shines an interesting light on the predicaments of the Eurozone. Comparing Iceland – a European Economic Area, EEA, country neither in the European Union nor the Eurozone – to debt-ridden Eurozone countries like Greece, Ireland, Spain, Portugal and Cyprus, shows that it is not the independent Icelandic currency that made the difference. Looking back, it can be argued that the low interest rates of the 2000s fooled both Eurozone countries and Icelanders, all used to high interest rates, into believing no other action needed to be taken apart from welcoming in the historically cheap money. Experience of the Eurozone debacle – and the Icelandic experience – should now have taught us that pricing risk at a rate close to zero does not reduce that risk to close to zero.

What does make a difference is the old-fashioned notion that even within a loose currency union like the Eurozone each country is responsible for its own destiny. The European Central Bank, ECB, is a central bank only in name. Each country remains in control of its own fiscal and industrial policy and is responsible for responding to country-specific productivity shocks and thus its economic destiny. Consequently, each country has to guide its own fiscal policy.

Further, it is interesting to take a closer look at interest rates and risk in the Eurozone. The first decade of the euro did not bring about the convergence of economic fundamentals so intensely wished for by the founding fathers of the Euro. Nominal short-term interest rates in the Eurozone did converge towards levels earlier enjoyed by the Deutschmark. Thus, the convergence of interest-rates did bring about divergent development of aggregate demand. The countries on the periphery of the Eurozone experienced demand-driven wage and price inflation from which the centre, Germany, was spared (Wren-Lewis, 2013).

Paradoxically the convergence of interest-rates that happened after the introduction of the Euro in the medium run instigated a divergent development of competitiveness between the centre and the periphery. Countries with strong a competitive advantage, like Germany, built up an ever-increasing current account surplus. In countries with booming demand and weaker development of competitiveness, like Greece, Ireland, Spain and Portugal, their lenders cheered the new circumstances of the low-interest free-flowing euro funding. Ignoring the need for structural adjustment, these countries and their lenders turned a blind eye to the dangers of the ever-increasing current account deficit.

In the end reality caught up with them: the imbalances were too big to correct in a piecemeal way. The unobserved story in the financial ruins of the Eurozone is the old story of a badly used boom.

October 2008: collapsing banks, in Iceland and elsewhere

On September 5 2008 the *Financial Times* reported that the ECB was to tighten its rules on collaterals where underlying assets were not denominated in euros, to be implemented in February 2009 (Atkins, Davies, & Sakoui, 2008). The changes reflected the concern that some banks were “gaming the system.” According to the report, the changes were expected to hit two banks, among others: Lehman Brothers and Glitnir, the smallest of the three big Icelandic banks. Both banks were at the time seen to have created collateralised loan obligations, backed by risky debt. By mid-September 2008 Lehman had failed; by the end of September Glitnir followed suit.

On September 29 2008, the Irish government, faced by an imminent risk of a run on the entire Irish banking system, issued a blanket guarantee for the liabilities of all Irish banks incurred from that date and for the next two years, later extended to end of March 2013 (Molloy, Garvey, O'Brien, & Prentice, 2013), as the banks were in a desperate need of refinancing and no lenders in sight. If the boards of the banks understood the gravity of the situation their actions did not reflect any such understanding: in 2008, the three largest banks had paid out €1.55bn in dividends, some of it as late as four days before the guarantee was issued (Honohan, 2010).

The international financial system was shaken to its core as trading in the interbank market all but stopped; nobody wanted to hand good money over to an entity that might be bankrupt within hours. With the exception of Lehman Brothers, an investment bank, both the US government and governments in various European countries set about to prevent banks from failing. In Iceland, Glitnir was the first to concede it was out of funds. On the same day the Irish government announced its blanket guarantee, the Icelandic government announced it would save Glitnir by injecting €600m of new equity only to abandon its plan just days later. On October 6 2008, the day regarded as the “day of collapse” in Iceland, the Central Bank of Iceland, CBI, attempted to save Kaupthing with a loan of €500m. Only Landsbanki was left to its own destiny. By October 8 2008, all three banks had failed.

In just five years, from 2003 to August 2008, the combined balance sheets of the three main Icelandic banks grew from 154% of Icelandic GDP to 865% (Sigríður

Benediktssdóttir; Jón Daníelsson; Gylfi Zoega, 2011). In Iceland, this phenomenal growth was hailed as a huge success, which meant that the collapse came as a great shock and surprised most Icelanders. They believed Icelandic bankers' and politicians' assurances of the banks' rude health. The public dismissed foreign observers as envious competitors when they pointed out the risks of a "hard landing" for the Icelandic economy.

In November 2008 Iceland sought the help of the IMF. The IMF-supported programme for Iceland included a loan of \$2.1bn and had three objectives: "to stabilize the exchange rate, put the public finances on a sustainable path, and restructure the financial system." [See (IMF Survey Online, 2011)].

In the years before the collapse the CBI steadily increased its policy rate, making Iceland an alluring destination for foreign exchange carry trade much like the South-East Asian countries in the late 1990s. Soon after the collapse of the banks it was clear that distrust in the currency and the situation in Iceland and elsewhere was causing the "hot" money to flow out. By the end of November 2008 Iceland, in agreement with the IMF, was forced to suspend freedom of movement of capital, one of the fundamental freedoms of the European Economic Area agreement. Five years on, capital controls are still in place.

In addition to Iceland and Ireland, Greece, Portugal, Spain and Cyprus ran into a sovereign debt crisis, with the long-declining Italy hovering precariously close to a crisis. Most crisis-hit countries pulled out the knives to cut state spending as soon as the crisis hit. The exception was Iceland, which with the blessing of the IMF postponed cuts and fiscal tightening for one year. Instead, Iceland relied on tax-hikes rather than expenditure cuts during the initial phasing of the programme.

Now, five years after the collapse of Lehman Brothers the situation in Iceland and the other crisis-hit countries is very different. Production in Ireland and Spain has evolved at an annual pace of 1.5 to 1.6% p.a. as elsewhere in the OECD. Greece is still below the 2007 GDP level in real terms while Iceland is producing the same real value as it did in 2007. The unemployment-rate is more than 2 percentage points higher in the OECD in 2013 than in 2007. The Icelandic unemployment-rate has increased a bit more in absolute terms, 3.7%, which is next to nothing when compared to the increase in Ireland, Spain and Greece, cf. Table 1.

Furthermore, governmental debt levels have increased two to three times faster not only in Ireland, Spain and Greece (55%-100%) but also in Iceland (78%) compared to the OECD average (37,6%). Disposable domestic income has contracted by 10 to 20% in Ireland, Spain and Greece reflecting increased transfer of interest-payments to foreign creditors. Thus, even if production is bouncing back, living standards are still depressed and will remain so as long as the countries are reducing the debt burden of the sovereign and regaining competitiveness.

Table 1: Development of key macroeconomic indicators in selected crises countries, 2007 to 2013,
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	Iceland	Ireland	Spain	Greece	OECD
Gross Domestic Product 2013/07	100,3	108,9	107	95	110
Absolute change in unemployment 2007 to 2013	3,7%	10,2%	16,6%	16,4%	2,3%
Relative change in Government debt ratio 2007 to 2013	78,3%	100,7%	55,4%	64,4%	37,6%
Gross domestic national disposable income ratio 20012/2007	79,4 (net national income at market prices)	84,3	92,8 (net income)	81,3	

Icelandic myths – and the facts

Iceland was the first crisis-country to return to growth in mid-2011. With falling unemployment Iceland has enjoyed some admiration. Much has been written about the Icelandic recovery and the country has been held up as an example for doing well in spite of not saving its banks and thus avoiding to burden the sovereign with bank debt.

Interestingly, much of the analysis of the relative success of the Icelandic road to recovery has been misleading, or outright wrong. Some of it has by now been so often repeated that the recovery is shrouded in persistent myths. The most common myths are the following:

1 Iceland refused to bail out bankers

Iceland was never in a position to bail out its banks, but this did not stop the government from trying. Soon after Glitnir sought help in late September 2008 the government announced it would nationalise 75% of Glitnir by putting up €600m in equity, writing down existing equity to €200m, consequently forcing a loss of 75% on shareholders. It only took a few days to dawn on the government that this proved beyond the means of the state and the plan was abandoned.

Interestingly, the abandoned bailout plan indicates that the Icelandic government assumed the shares of at least one systematically important bank were overvalued. Meanwhile, other governments attempted to shore up the share value of systematically important banks. Some investors may have inferred that Icelandic bank assets were more toxic than assets of other banks.¹

On October 6 2008, the government finally understood that all three banks were beyond salvation. In the evening, emergency legislation was passed granting the government the power to take over financial institutions as the country itself would otherwise be faced with what prime minister Geir Haarde (Independence Party, conservative) called “a sovereign default.” Yet, on that same day, the CBI, with the blessing of prime minister Haarde attempted to save Kaupthing, double the size of Glitnir and Landsbanki combined, with a loan of €500m using Kaupthing’s subsidiary FIH/Erhvervsbank, a Danish bank, as a collateral. Less than 48 hours later Kaupthing had failed. Accepting a bank as a collateral was in itself an unusual decision. The motive for this loan has never been clarified, what persuaded the CBI and the prime minister to attempt to save Kaupthing at this late stage, nor is it clear where the €500m ended up, (Sigrún Davíðsdóttir, 2013).

A simple calculation shows how futile these attempts were. Assume that the Icelandic sovereign had nationalised the three big banks the owner, the Icelandic sovereign, would have had to strengthen the equity position of the now nationalized banks, by borrowed funds. Even if the assets of the banks had, in October 2008, been written down by a mere 20% of their estimated value in early 2008 this would have burdened the Icelandic sovereign with a debt amounting to 200% of GDP. A more realistic valuation of the banks assets in October 2008, such as a write down of 30-50% of early 2008 value, would have left the sovereign with a debt of 300-500% of GDP.

Over the coming months and until mid 2009, the Icelandic government saved two small investment banks, which failed in early 2010, some savings societies and an insurance company.

Consequently, the reality is that the government tried unsuccessfully to save two of the three main banks and later saved some smaller financial institutions, with mixed results. In total, 90% of the Icelandic financial system failed from October 2008 until mid 2010.

2 The sovereign suffered no losses from the failure of the banks

This is unfortunately not true. As we have shown in a previous article the expected direct cost accruing to the state was in the range of 20-25% of GDP, (Þórólfur Matthiasson; Sigrún Davíðsdóttir, 2012). Our findings are broadly supported by the IMF, (Laeven & Valencia, 2012).

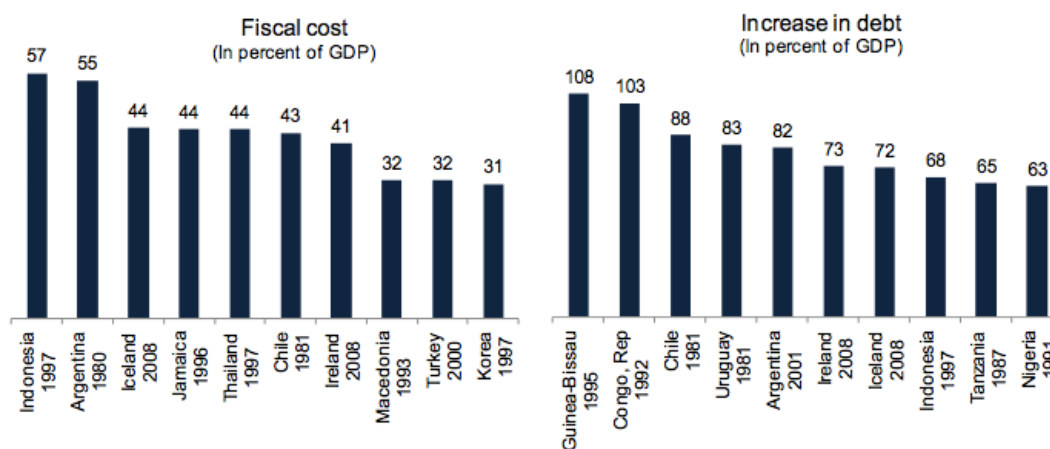
¹ Top managers in all three banks have been charged by Office of the Special Prosecutor for market manipulation. All cases are still pending.

The Icelandic sovereign suffered severe revenue loss and a surge in crisis-relief expenditure with the net public debt increasing by 80% of GDP from beginning of 2008 to 2013. This clearly shows the high direct and indirect cost of the collapse accruing to the public purse.

In addition, Iceland has long prided itself of the world's best pension system, introduced in the early 1970s. Icelandic pension funds were avid buyers of bank bonds, in addition to buying uncovered bonds from various holding companies, owned by the banks' biggest shareholders. The losses amount to ISK380bn, or around 20% of GDP.²

As shown by Luc Laeven and Fabián Valencia, the cost puts Iceland on the top ten list of costliest banking crises since 1970, (Laeven & Valencia, 2012).

Figure 8. Costliest Banking Crises Since 1970



3 Iceland will not pay a penny to the UK and the Netherlands towards IceSave

This is unfortunately not true. In 2006, following negative analyses by foreign financial institutions the three Icelandic banks, which had financed their meteoric growth by borrowing on international markets, experienced a funding draught. In autumn 2006 Landsbanki set up its IceSave high-interest Internet saving accounts in the UK, followed by IceSave in the Netherlands in spring 2008.

The bank collapse in October 2008 triggered two significant events. First, the UK and the Dutch government presented claim originating from Landsbanki's IceSave clients, respectively £2.35bn and €1.3bn, (Alpingi, 2009). The Icelandic Deposit Guarantee Fund, DGF, did not have access to funds to meet the claims. Partly in order to prevent a run on

² This number is from a report, published in February 2012, by a committee set up at the behest of the Icelandic Pension Funds Association, (Bragason, Frímansson, & Eyjólfsson, 2012) – however, others deem this number to be too low.

their own banks, the governments of the UK and the Netherlands decided to reimburse IceSave depositors, understanding they would, in due course, recover the funds from the Icelandic government.³

Second, all three banks were split into a new and an old bank, with the three new banks overtaking domestic operations and deposits while the foreign operations were kept within the old failed banks. Consequently Glitnir and Kaupthing, owned by the creditors of these two failed banks, own respectively 95% and 87% of the new banks, Íslandsbanki and Arion.⁴ However, due to IceSave, the two largest creditors of Landsbanki are the deposit guarantee funds of the UK and the Netherlands. These two creditors, fearing that the Icelandic government would not reimburse the IceSave funds, did not agree to become owners of new Landsbanki. This forced the Icelandic state to take over ownership of Landsbanki, thereby de facto guaranteeing the bank.

When Landsbanki was split up in old and new bank, respectively named LBI hf and Landsbankinn, the value of assets transferred from the old bank to the new was higher than the value of liabilities transferred. To close this gap the new bank eventually issued two bonds, to be repaid in foreign currency during the period 2014 to 2018. The bonds are valued at ISK297bn or 17% of GDP on the balance sheet of Landsbankinn. Hence, Iceland would have to double its current account surplus from 5% of GDP to 10% of GDP during the repayment period in order to honour it. Refinancing and/or rescheduling the bonds, seen as a crucial step towards abolishing the capital controls, is now being negotiated.

The Icelandic government attempted three times to negotiate with the Dutch and the British government on IceSave. The last two agreements were sent to a referendum but turned down. The two referenda were not on bailing out banks or bankers, as often stated in the media, but on giving the government the right to guarantee a top-up in case funds from the Landsbanki estate were insufficient to cover the amount, (Þórólfur Matthiasson; Sigrún Davidsdóttir, 2012). As of November 2013, the estate has paid out 44% of the IceSave funds due to the UK and the Dutch governments and it is clear from the estate's recovery that it will cover the rest over time.

The two Landsbanki bonds, initially a matter of internal accounting between the failed and the new Landsbanki, now determine the rate of repayment. Contrary to what the IceSave agreements sought to stipulate the repayment-schedule of the bonds is not tailored to macro-economic conditions of the country. This has created an unforeseen risk

³ Contacts between Icelandic, Dutch and British authorities all indicated that the Icelandic government intended to reimburse foreign IceSave deposits. Documents related to the initial contacts can be found on the website of the Icelandic Prime Minister's Office: <http://www.forsaetisraduneyti.is/verkefni/verkefnum-lokid/adgerdir/icesave/nr/4578>.

⁴ The remaining stakes, respectively 5% and 13% is owned by the Icelandic state, through Icelandic State Financial Investments, ISFI; see <http://bankasysla.is/forsida/>

acknowledged by the CBI and other observers including the IMF, (Central bank of Iceland, 2013). It is difficult to estimate the cost of this risk and the resulting uncertainty but it is part of the cost of not settling the IceSave dispute by agreement between Iceland and the two creditor countries.

In addition to this new risk, stemming from the misalignment of repayment plans with macro-economic conditions, refusing to ratify the successive IceSave agreements has not been costless. The UK and the Netherlands managed to delay payment of the first tranches of the IMF loan to Iceland in 2009, thus delaying efforts to restart the economy. Furthermore, in absence of a repayment profile-agreement with the UK and the Netherlands the Icelandic state will either have to issue new bonds on the international capital market, risking crowding out other domestic actors and/or increasing risk-premiums. Alternatively the state will have to double its current account surplus, which even in the best of times would be an elusive goal.

4 Independent currency and 50% depreciation is the key to the Icelandic success

In the years before the bank crash, high interest rates had driven up the price of the Icelandic króna. Its real exchange rate was 20 to 30% above its value in 2005 to 2007. In late 2007 it started depreciating and may well have reached its purchasing-power-parity equilibrium value by mid 2008, falling yet further in October 2008.⁵

Before the collapse, the appreciation of the króna had hurt export profits. The immediate effect of the collapse of the króna was to destroy the balance sheets of most businesses in Iceland and of households, lured by low foreign interest rates to switch from domestic to foreign currency financing of their debt. The social democrat-led government, which came to power after elections in March 2009, initiated one of the most comprehensive write-down programmes in the world to prevent whole-sale bankruptcy of the business sector (see below).

So far the effect of depreciation has been predictable: export-revenue has increased, while import expenditure has contracted. Unfortunately, the structure of the economy hinders it from reaping some of the benefits of depreciation. Its small consumer-base restricts domestic production of consumer goods. In theory, depreciation directs flow of labour and capital from importing activities to exporting ones. However, the two most important export sectors, aluminium and fishing, are constrained by natural restrictions,

⁵ On quarterly basis the real exchange rate of the ISK reached its peak in the fourth quarter of 2005 (index value of 118,1; according to the relative CPI-real-exchange rate index calculated by the CBI; <http://www.cb.is/statistics/statistics/?newsid=ee3108d2-5c77-4175-b078-cad89c487627&stdID=20>). In the first quarter of 2008 it is 15% lower than the peak value (index value of 100). Fell by 11% from Q1 to Q2 and further by 23% from Q2 to Q4 (index value 68). The index has hovered around 75 since Q2 of 2010.

electricity generation capacity and fishing quotas, neither of which responds to fluctuations in currency prices.

Tourism is now booming but there is good reason to worry that since it is a low-wage industry, competing with low-cost destinations around the Mediterranean, tourism may not stimulate much long-term growth. In addition there are signs that this industry might be experiencing capacity-restrictions. Popular sights are getting more crowded and visitors find it increasingly more difficult to experience solitude, which is what brings many tourists to Iceland.

Hence, the devaluation of the króna has effectively curbed domestic demand by reducing purchasing power of Icelandic consumers. The devaluation has affected the supply side much less profoundly. If, in line with expectations, demand rebounds, the devaluation will have had minimal lasting effects.

The cost-benefit analysis of the króna includes tallying the cost of prolonged capital-controls and the cost of excessive debt-relief programs as well as the traditionally recognised costs of holding a small currency, i.e. higher interest rates, volatility and transaction costs. Reducing unemployment by a basis point or two over a two-year period would account on the benefit side, but might well be dwarfed by cost associated with the above.

An independent currency is a major reason for the capital controls in Iceland. The IMF recently reckoned it might take eight years to abolish them (International Monetary Fund, 2013). Yet, IMF is more on the optimistic than the pessimistic side. The cost will, no doubt, be the same as in other countries that have had capital controls for years: an asset bubble, business behaviour adapted to rent-seeking, loss of competitiveness and less foreign direct investment, to name a few well-known damaging and loss-lasting effects.

Iceland is not the only country that has, over decades, used devaluation as a policy tool. Devaluation, being alluringly easy to use, can instigate certain laziness and push out other measures to “correct” the economy. This tool, so ingrained into Icelandic economic thinking, might tend to make Icelanders blind to its cost and adverse effects.

Iceland and the IMF program

As mentioned earlier, the IMF programme for Iceland focused on stabilising the exchange rate, putting public finances on a sustainable path, and restructuring the financial system. By the time the programme expired, in 2012, the IMF reckoned that all three objectives had been met, (IMF Survey Online, 2011).

As in other countries, which have been forced to seek IMF involvement, some Icelandic politicians and commentators strongly opposed this move. The most vocal protest came from some Left Green members of parliament that were part of the coalition government from March 2009 until summer 2013. These critics maintained that the IMF had a track record of demanding consolidation of public finances with cuts in welfare expenditure and increasing taxes on the poor while others pointed out that taking a loan to strengthen

the currency reserves would not alter the net external position of the country, (Lilja Mósesdóttir, 2013).

On these accounts, the critics have been proven wrong. The IMF and the government agreed to postpone any cuts for a year, accepting a budget deficit of up to 10% of GDP in 2009, before nudging towards a balanced budget over a period of four years, now delayed but expected to be reached in 2014. The IMF left it to the government to figure out the details of consolidation plan. Compared to Greece, Iceland had a strong ownership of the program, in general seen as a prerequisite for a successful outcome.

Within the programme, the financial system was restructured and the zombie-bank problem avoided, so far. However, the latest CBI report on financial stability indicates that more is needed, see the Financial Stability Report for 2013, pp. 23-24, (Central Bank of Iceland, 2013). Capital controls and enlarged currency reserves calmed foreign capital markets to the extent that the Icelandic sovereign was able to issue a \$1bn bond already in late 2011, (Ministry of Finance A, 2011).

Without the assistance of the IMF the Icelandic government would hardly have been able to implement policy with so much Keynesian flavour. On its own Iceland would have struggled implementing capital controls, in breach of the fundamentals of the EEA agreement. Further, Iceland might have struggled to muster the credibility and trust necessary to defend its position on foreign capital markets, let alone to issue new bonds to finance deficit spending.

Two uniquely Icelandic measures: debt relief and shortened bankruptcy period

Iceland has not been spared from cuts in public spending though the cuts were postponed for a year. However, two measures were taken in Iceland that have generally not been applied in other European crisis hit countries. One is debt relief, the other is allowing discharge from bankruptcy after only two years.

Following the collapse of the currency, the cost to both households and companies of servicing loans, either indexed loans or loans in foreign currency, shot up and so did arrears. The problem was obvious to politicians and financial institutions but it was only after a heated debate that the government and the financial sector finally agreed on a comprehensive debt-relief programme for households and companies. The main focus was on providing fair and standardised measures available to all, as long as certain criteria were met. Debt relief did not create new equity for either households or firms.

Households were offered to have debt above 110% of the fair value of each property written off. Secondly, the government provided a temporary subsidy to low-income, asset-poor households with high-interest mortgage payment.

In addition, a new office of a debtors' Ombudsman was set up, both to advise households on measures available and to find solutions where the standard debt-relief measures proved insufficient.

Small-to-medium sized companies, able to document positive cash flow from future activities, could apply for debt-relief given they were willing to restructure operations in order to make best use of assets. The write-down would then either equal the discounted value of future earnings or, alternatively, be measured against what the lender could expect to gain from taking over the assets.

Although the financial sector was at first reluctant to accept these measures, there is now a general consensus that the measures were a success.

Through write-downs bankruptcy risk for companies was minimised, which helped to rebuild the trust with foreign business partner, lost with the collapse. Another trust-enhancing factor was the weeding out of bad companies, leaving the firms that were left with sustainable balance sheets.

The tax base was strengthened by companies staying active, retaining employees who instead of being on unemployment benefits were on salaries.

The government was a key actor in co-ordinating these measures, in making sure that banks would not have conflicting interests in individual cases. New laws forced the banks to make a concerted effort, assigning each firm a coordinator within the bank. Competition issues also had to be solved, again necessitating government involvement.

Another important measure was to allow discharge from bankruptcy, given certain conditions, after only two years, instead of nine years. This measure is of vital importance in countries where banks hold a high amount of non-performing loans.

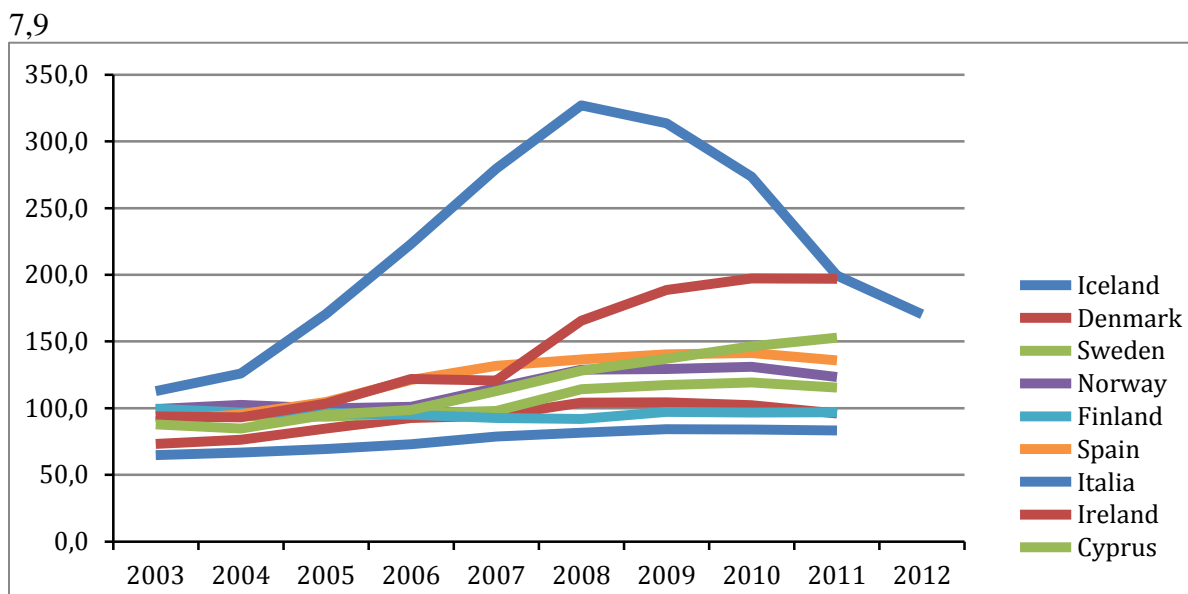


Figure 1: Corporate sector debt as percentage of GDP, selected countries

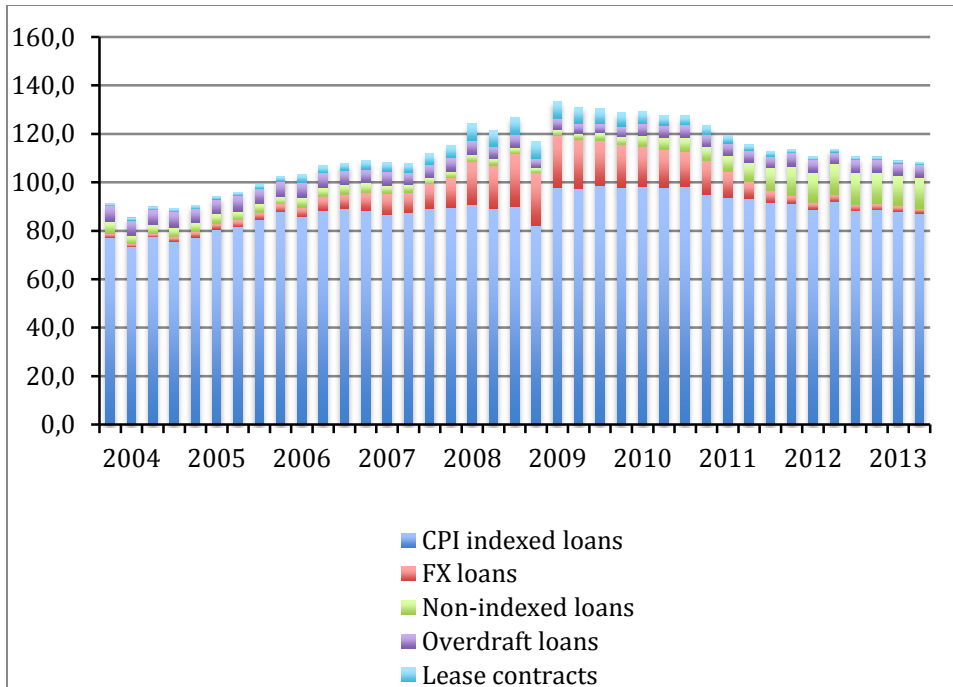


Figure 2: Household loans in Iceland as percentage of GDP, by category, source CBI, Financial Stability report

The Icelandic experience indicates that postponing necessary write-downs of both household and company debt is only pain and no gain, not only for families and firms but also for the state. The write-downs seem to have promoted growth and sustained economic activity without hurting balance sheets of the financial sector.⁶ This seems to square with lessons from earlier crises, the Japanese being an interesting case in point; interestingly, Tang and Upper note that Japanese banks did not start lending to the private sector again until they had dealt with the non-performing loan problem on their balance sheets, (Tang & Upper, 2010).

⁶ The Icelandic banks are now well capitalised and the Central Bank does not list debt levels of the private sector as the biggest threats to financial stability of the country.

Iceland, Ireland and Greece – three very different IMF programme-countries

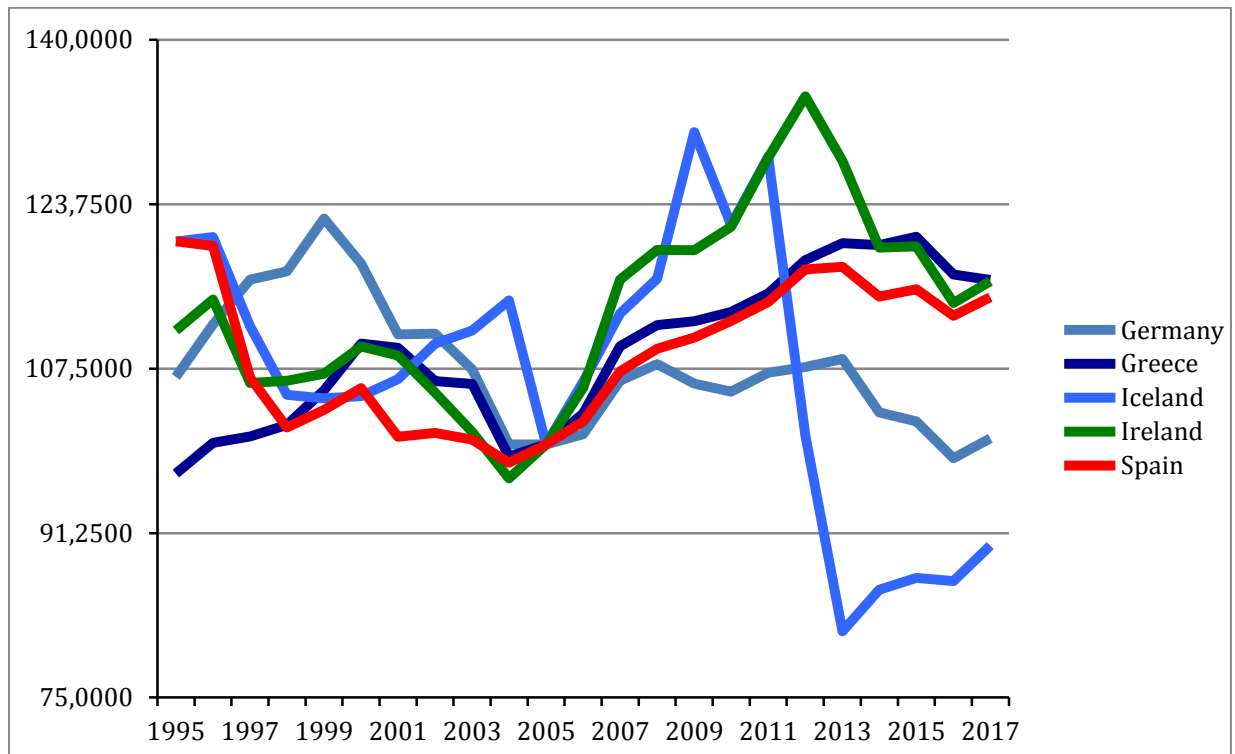


Figure 3: Real effective exchange rate, selected countries, 2001=100. Source: IMF, DataMarket, authors' calculation

As pointed out earlier the competitiveness of Greece, Ireland and Spain was eroded from 2000 until the onset of the financial crisis in 2007. Falling competitiveness is reflected in the development of the real exchange rate for those countries, cf. figure 3. The Icelandic króna also appreciated during the same period. For the euro countries it was the tight monetary policy stance of the ECB; for the króna the mix of loose fiscal policy and tighter monetary policy partially explains this development. But as the case of Germany proves, tight money is only a partial explanation of rising real exchange rates and reduced competitiveness.

As pointed out earlier, access to cheaper funding induced increase in demand and stimulated economic activity on Eurozone periphery in the years after the introduction of the euro. The Icelandic economy enjoyed investment-led stimulus. Thus, prior to the crisis Iceland, Spain, Ireland and Greece all endured Dutch disease-like spells. High internal prices and wage levels discouraged exports and encouraged imports, sustained by a steady inflow of cheap money. The brakes that should have stopped the sustained overspending of the domestic sectors in these countries did not work.

In the Greek case creditors were mistaken about the real cost of lending to the sovereign of Greece, (Ioannou & Ioannou, 2013). In the years after Greece joined the Eurozone, the risk premium of Greek sovereign bonds was a few paltry basis points over that of the German Bund. In Iceland, creditors flocked to buy “glacier bonds,” bonds in Icelandic

króna, to reap the gains from the high level of nominal and real interest rates, ignoring the risk of future devaluation.

The real cost of financing the Greek sovereign debt increased dramatically after the breakout of the global financial crisis made Eurozone periphery sovereign bonds a toxic asset in capital markets. Financial and macroeconomic data, open to the rating agencies as to others, were suddenly reinterpreted. Although the Greek statistics were found to be misleading key numbers were available from Bank of International Settlements, BIS. Faulty Greek statistics during these years can hardly be blamed for the irrational exuberance that took hold on all sectors of the global economy for a while.

To begin with, the main focus of the Greek Troika programme was austerity, largely dictated by Germany. Two rationales can be given: a) an attempt not to create a precedent, if and when much larger economies such as those of Italy, Spain and possibly France, would require a similar bailout and b) an attempt to bring the funding and the size of the public sector to a sustainable level and hopefully be awarded by lower risk premiums and lower interest costs on sovereign bonds. With hindsight, the probability of success seems to have been overestimated and the cost of failure underestimated.

The cause of the Icelandic Dutch disease is the overheating of the economy during the early 2000s and the ensuing carry trades, (Þórólfur Matthiasson, 2008). Iceland could start the process of correcting the real-exchange rate by devaluating the currency; Greece, Ireland and Spain have had to go the painful path of internal devaluation. Traditional devaluation instantly enhances the competitiveness of an economy though it tends to be eroded even if inflation is contained as is evident from the development of the real exchange rate for Iceland after 2009. Internal devaluation is a time- and effort-consuming activity, competitiveness improves slowly but the gains tend to stick. Hence, the path of Greece, Spain and Ireland to recovery was bound to be slower than the Icelandic path.

All the countries could have avoided the Dutch Disease situation with better economic policy and better institutional arrangements. Note also that even if we leave out the long-term costs of the Icelandic devaluation it would not explain much in terms of employment effects as already accounted for.

The fact that Iceland was allowed to let “automatic stabilizers” work their way for the first two to three years of the IMF-programme, differentiated the Icelandic programme from the Troika programmes in the Eurozone countries. This meant that Iceland did not follow the path of austerity staked out for Greece and the other European programme-countries. For Iceland, Keynesian effect was accepted whereas supply side policies were the only option given to Greece, even by consciously underestimating the costs of austerity as the case of the fiscal multipliers⁷ has shown, (Blanchard & Leigh, 2013).

⁷ A small fiscal multiplier implies that a cut in public spending will have negligible effect on GDP and employment. A big fiscal multiplier implies the opposite. As alluded to by (Blanchard & Leigh, 2013) fiscal multipliers and thereby the potential

The support of the IMF signalled that the Icelandic government had a credible plan for future consolidation of the public finances. Another major difference is the debt relief programmes already mentioned. It cannot be overemphasized that these programmes saved jobs and probably prevented a domino effect of bankruptcies as the bankruptcy of one firm erodes the equity position of one or more other firms.

Sound economic policy, before and after the crisis, matters – no matter the currency

Most of the studies of the European debt-hit countries – Ireland, Greece, Portugal, Cyprus and the partly bailed-out Spain – have focused on the effect of euro membership on these countries.

Adding Iceland – a non-EU, non-euro member but a member of the European Economic Area – gives an interesting comparison, which to a certain degree changes the perspective of the “better/worse off in the euro” debate.

Under floating exchange rate, textbook theory predicts that overspending by the domestic sector will automatically cause depreciation of the domestic currency, eroding purchasing power, enhancing the competitiveness of domestic businesses. Fixed exchange rate regime lacks this automatic adjustment mechanism opening up the possibility for extended periods of over- or undervaluation of the currency and extended periods of increasing external deficits and foreign debt. The experience of Iceland during the 2000s clearly shows that expectations, poor judgement and speculative behaviour can force an overvaluation of a floating currency for extended periods of times. The floating exchange rate is not an automatic guarantee against overspending and undersaving⁸.

It can be argued that all these countries – Iceland, as well the European crisis-countries – should be seen as emerging markets in the early 2000s, very much like the South-East Asian countries in the late 1990s. With the exception of Iceland, the fast-growing EU countries did not offer high interest rates but they offered international banks huge scope for lending into countries hungry for cheap credit. In return, Greece offered an increasing and stable supply of sovereign bonds that were assumed to be as safe as if issued by the German Ministry of Finance. Similarly, the Irish, the Portuguese, and the Spanish sovereign were apparently assumed to have access to enough funds to bail out banks in trouble.

The apparent prosperity, brought to Iceland and other fast-growing European countries on waves of low-interest capital, was taken as an indication that these countries, paying

harm caused by fiscal consolidation (austerity) were, until mid year 2012, assumed to be small even if the econometric evidence for that assumption might not “carry the argument”.

⁸ A foreign stock traders operating in the Icelandic market in 2004 to 2006 asked one of the authors, at the time, why the Central Bank was so worried about the current account, adding “No need to worry about that when you have floating exchange rate.”

interest rates like or close to sound Germany, were doing everything right. However, ignoring the message contained in constant current account deficit turned out to be fatal.⁹

Consequently, these countries were lulled into believing that their economy was sound and strong. In all countries education was probably not prioritised as it should have been. Too little was done to unshackle the Greek economy from the grip of vested interests. The same can be said for the other crisis-countries. Spain did not pay attention to how difficult it is to set up a company in Spain and it did not change the counterproductive labour protection rules, laws and contracts until after 2008. Ireland and Greece did little to strengthen their tax collection systems until after 2008. Iceland did not strengthen its financial oversight capacity until after the financial system collapsed.¹⁰

In all the crisis hit countries the list of what was left undone during the good years is long.¹¹ In addition, a country like Italy, able to pile on domestically held debt, can also look back on the past decade as a lost opportunity. In countries where corruption is ingrained in the economy and politics, too little was done to root it out, leaving the hidden cost of corruption to suck blood out of the contracting economy. The BRIC countries are now facing the same, both in terms of reform and dealing with corruption, (Åslund, 2013).

Earlier, Western financial institutions wrecked havoc in Asia as money flows were directed into countries with high-interest rates. This time, the booming emerging markets were in their own backyard. For the first time since the early 1970s, the IMF had to manage a crisis within Europe.

As soon as the credit bubble burst, Iceland, Ireland and other European countries finally realised that the capital amassed had not been put to productive use. In fact, it left many banks insolvent. The first decade of the euro coincided with international markets being flush with low-interest funds post 9/11. In many euro countries but also in Iceland this decade was badly used.

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http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Balance_of_payment_statistics

¹⁰ The irony is that Iceland had lax control and few controllers for a big financial sector but now has stricter controls and far more controllers controlling a sector almost five times smaller.

¹¹ In his book, *Austerity: European Democracies Against the Wall* 2013 and in an article, *Austerity and Stupidity*, November 6 2013 <http://www.voxeu.org/article/austerity-and-stupidity> Lorenzo Bini Smaghi points out the connection between “poor and unbalanced growth performance before the crisis, which was due to the lack of reform” and the post-crisis development where austerity was the only policy. Instead, what would be needed is “more fundamental structural reforms which increase growth potential and create the room for manoeuvre for a more gradual fiscal adjustment.”

In political debate, the European bail-outs have all too often been explained by troubles stemming from outside – in the euro countries from the euro, in Iceland from outside forces. The painful thing to admit, for each of the crisis-hit countries, is that in all of them the crisis was home-spun.

The Euro did not save the euro countries – and Iceland, outside the euro, was not saved either by being outside. The experience of these European countries can be interpreted not as depending only on a euro membership or not – but as an indication that the old adage that each country is a master of its own economy is as true now as always. What these countries failed to do was to pursue a sound economic policy in good times. That is the true lesson of the crisis in the Eurozone countries and Iceland.

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